No. 9946

United States Circuit Court of Appeals

For the Ninth Circuit

FRANK BOGART,

Appellant

vs.

MILLER LAND AND LIVESTOCK COMPANY,

Appellee.

Brief for Appellant

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Filed .....1941.

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INDEX

AUTHORITIES CITED

STATUTES

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JURISDICTION

This is a bankruptcy proceeding instituted pursuant to the provisions of Section 75 of the Bankruptcy Act (11 U. S. C. A. 203). The appellee made a proposal for an extension of time to pay its debts (R. p. 2). The proposal was confirmed and approved by the Court (R. p. 44). The appellant presented and filed a claim for $150,000.00, with interest thereon at the rate of six per cent. per annum from the 1st day of October, 1937, secured by mortgages upon the real estate of the debtor (R. p. 13). This claim was allowed and approved as filed (R. p. 49). The appellee filed a petition for a reduction of the rate of interest on the claim (R. p. 66). Ap-

pellant filed objections to the granting of the petition (R. p. 73). The objections were over-ruled and an order made reducing the rate of interest to four per cent. per annum (R. p. 74). The appeal is from this order. (R. p. 74).

Jurisdiction of the appeal is conferred upon this Court by Subdivision (a) of Section 47, Title 11, U. S. C. A., as amended which provides:

> "The Circuit Courts of Appeals of the United States * * * are hereby vested with appellete jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise or reverse both in matters of law and in matters of fact."

STATEMENT OF THE CASE

The claim of appellant is secured by mortgages upon the real estate of the debtor, appellee, who acquired the property subject to the mortgages without any assumption or agreement to pay the mortgage indebtedness.

In paragraph V of the verified petition for the reduction of the rate of interest, it is stated:

> "That the claim of the creditor herein is based upon a debt secured by a first real estate mortgage upon property that at the commencement of this proceedings was worth greatly in excess of the amount of the said mortgage

thereon. That since said time Debtor, to increase the value and productivity thereof in order to pay off the said Frank Bogart and the other creditors as soon as possible and to preserve to the petitioner its valuable equity in said property, has made extensive and valuable improvements of such real estate and has secured property, necessary and adequate equipment to increase the income therefrom." (R. p. 68).

In paragraph III of a verified answer and cross-petition filed by appellee to an application by appellant for permission to foreclose his mortgages, it is stated:

"That since the commencement of this proceeding the Debtor has increased the value of the security of the said Frank Bogart in excess of $100,000.00 and that such improvements and repairs were necessary and proper in order to increase the productivity of the Debtor estate as a whole in order to more quickly and surely pay off the creditors of Debtor in accordance with its proposal. That the real estate upon which first mortgages exist claimed by Frank Bogart covers about 16,000 to 18,000 acres of the approximately 26,000 acres of the deeded land owned by Debtor and that the cost of all of said land was $1,102,908.33, and said land has now been improved as above stated and approximately eighty per cent of said land and value are subject to said mortgages of the said Frank

Bogart. That due to unusual financial and general economic conditions and existing litigation between Debtor and Fra and E. L. Dana pending in this Court and as yet un-adjudicated, Debtor has so far been unable to refinance the said Bogart claim but alleges that the said Frank Bogart is secured to an extent that to permit him to foreclose his said morgtgages would enable him to take security worth $800,000.00 for a claim of approximately $180,-000.00". (R. pp. 63-64).

The validity of the order reducing the rate of interest is the question for decision by this Court.

SPECIFICATIONS OF ERRORS

1. The Court erred in reducing the rate of interest (R. p. 74).

2. The Court erred in deciding that the application for a reduction of the rate of interest presented a proper case for the allowance of a reduction.

3. The Court erred in deciding that it had authority to entertain the application (R. p. 74).

ARGUMENT AND AUTHORITIES

COURT WAS WITHOUT AUTHORITY TO REDUCE RATE OF INTEREST

According to all of the authorities, where the property mortgaged is ample security for the payment of the mortgage debt, the court, in a bankruptcy proceeding, is without authority to reduce the rate of interest. The mortgagee is entitled to

interest at the agreed rate until the mortgage debt is paid.

In the case of Coder v. Arts, 152 Fed. 943, decided by the Circuit Court of Appeals for the 8th Circuit, in an opinion by Circuit Judge Sanborn, it is said:

> "By the terms of the note and mortgage the mortgagor agreed to pay interest on his debt until it was paid, and that the mortgaged lands might be sold by the mortgagee, and that their proceeds might be applied to the payment of this debt and interest. The covenant for the sale and the application of the proceeds of these lands to the payment of the debt and interest was valid and binding, and it ran with the land, so that when the latter came to the hands of the trustee, *it was mortgaged for the payment of the interest as much as for the payment of the principal,* and the proceeds of its sale necessarily came to his possession subject to the same charge. Another rule might prevail if the proceeds of the mortgaged property were insufficient to pay the mortgage debt and its interest in full and the mortgagee was seeking to collect an unpaid balance by sharing with other creditors in the distribution of the common property. He might not be entitled, then, to recover from the proceeds of the common property interest upon his debt to any later date than the unsecured creditors would recover interest upon their claims. But the pro-

ceeds of these mortgaged lands appear to be ample to pay the principal and interest of the debt to the mortgage Arts, and where a trustee sells mortgaged property of the bankrupt's estate free of the mortgage, and the proceeds of the sale are sufficient for that purpose, the mortgagee is entitled to payment of the interest upon his mortgage debt as well as the principal, out of the proceeds in accordance with the terms of the note and mortgage." (Italics ours).

An appeal was taken to the Supreme Court of the United States in the case of Coder v. Arts, (213 U. S. 223, 53 L. Ed. 772), and, in concluding the opinion, the court said:

"Nor do we think the Circuit Court of Appeals erred in holding that, inasmuch as the estate was ample for that purpose, Arts was entitled to interest on his mortgage debt."

In the case of Ticonic National Bank v. Sprague, 303 U. S. 406, 82 L. Ed. 926, the court said:

"This Court has already held that a lienholder may look to his lien not only for the principal but also for interest accruing up to the date of payment, though his debtor has gone into bankruptcy" (Citing Coder v. Arts, 213 U. S. 223, 245, 53 L. Ed. 772, 782).

See also:

Mortgage Loan Co. v. Livingston, 45 Fed. (2d) 28;

In re Hagin, 21 Fed. (2d) 433;

San Antonio L. & T. Co. v. Booth, 2 Fed. (2d) 590.

The case of Sexton v. Dreyfus, 219 U. S. 339, 55 L. Ed. 244, has been sometimes cited in support of the contention that a secured creditor is not entitled to interest after the filing of a petition in bankruptcy by the mortgagor.

In the case of San Antonio L. & T. Co. v. Booth, cited above, the court said:

> "We are of opinion that the interest as specified in the mortgage, insofar as it can be satisfied out of the Loan and Trust Company's security, should be allowed up to the date of payment of the entire debt. * * * There is nothing in Sexton v. Dreyfus, 219 U. S. 339, 31 S. Ct. 256, 55 L. Ed. 244, in conflict with this view. In that case the secured creditors sold their securities after bankruptcy, and finding the proceeds not enough to pay principal and interest, attempted to apply the proceeds first to the interest which had accrued after bankruptcy, then to the principal, and finally to prove for the balance. It was held by the Supreme Court that this could not be done. But here the attempt is only to be paid out of the security."

Again, in the case of Peoples Homestead Assn. v. Bartlett, 33 Fed. (2d) 561, the court said:

> "We are of the opinion that appellant was entitled to interest on its mortgage up to the date of the completed sale."

The court further said:

> "Sexton v. Dreyfus, 219 U. S. 339, 31 S. Ct. 256, 55 L. Ed. 244, relied on by appellee, is not in conflict with the view indicated by the just quoted language. In that case the secured creditors had exhausted their security, and as to the fund in court were unsecured creditors. In Coder v. Arts, as in this case, the secured creditor had not exhausted his security, and sought to be paid, not out of a general fund that belonged to the unsecured creditors, but out of a special fund, derived solely from the sale of his security."

In foot note No. 31 to the case of Louisville Joint Stock Land Bank v. Radford, 295 U. S. 555, 79 L. Ed. 1593, in which the original Frazier-Lemke Act was held unconstitutional, it is said:

> "Counsel for the debtor suggests that the reasonable rental provided for in paragraph 7 is more than the secured creditor ordinarily receives in bankruptcy, since interest on secured as well as unsecured claims ceases with the filing of the petition. But the rule relied upon applies only when the secured creditor, having realized upon his security, is seeking as a general creditor to prove for the deficiency against the bankrupt estate. Sexton v. Dreyfus, 219 U. S. 339, 55 L. ed. 244, 31 S. Ct. 256, 25 Am. Bankr. Rep. 363. It has no application when the mortgagee has a preferred claim against proceeds realized by the trustee from

a sale of the security free of liens." (Citing Coder v. Arts, 213 U. S. 223, and other cases).

In the case of Bartles v. John Hancock Mutual Life Insurance Co., 100 Fed. (2d) 813, which involved a consideration of the Frazier-Lemke Act, as amended, the court said:

> "But secured creditors whose liens antedate the law have as to their security vested rights which must be effectuated."

In the same case before the Supreme Court of the United States, 308 U. S. 180, 84 L. Ed. 176, the court said:

> "The scheme of the statute is designed to provide an orderly procedure so as to give whatever relief may properly be afforded to the distressed farmer-debtor, while protecting the interests of his creditors by assuring the fair application of whatever property the debtor has to the payment of their claims, *the priorities and liens of secured creditors being preserved.*" (Italics ours).

It was because the Frazier-Lemke Act, as originally enacted, authorized the taking of the property of the mortgagee, in violation of the Fifth Amendment to the Federal Constitution, that the statute was declared unconstitutional.

> Louisville Joint Stock Land Bank v. Wm. W. Radford, 295 U. S. 555, 79 L. Ed. 1593.

It appeared in that case that Radford had mortgaged his farm to the Louisville Joint Stock Land Bank long prior to the enactment of the Frazier-

Lemke Act. In the opinion in the case the court said:

> "No instance has been found, except under the Frazier-Lemke Act, of either a statute or decision compelling the mortgagee to relinquish the property to the mortgagor free of the lien unless the debt was paid in full.
>
> This right of the mortgagee to insist upon full payment before giving up his security has been deemed of the essence of a mortgage."

The court further said:

> "It is true that the position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor, who has none; and that the Frazier-Lemke Act is the first instance of an attempt, by a bankruptcy act, to abridge, solely in the interest of the mortgagor, a substantive right of the mortgagee in specific property held as security. * * * * * Because the Act is retroactive in terms and as here applied purports to take away rights of the mortgagee in specific property, another provision of the Constitution is controlling.
>
> Fourth. The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment. Under the bankruptcy power Congress may discharge the debtor's personal obligation, because, unlike the States, it is not prohibited from impairing the obligation of contracts. Compare Mitchell

v. Clark, 110 U. S. 633, 643, 28 L. Ed. 279, 282, 4 S. Ct. 170, 312. But the effect of the Act here complained of is not the discharge of Radford's personal obligation. It is the taking of substantive rights in specific property acquired by the Bank prior to the Act. In order to determine whether rights of that nature have been taken, we must ascertain what the mortgagee's rights were before the passage of the Act. We turn, therefore, first to the law of the State."

The court then discusses the law of Kentucky and, referring to the Frazier-Lemke Act, said:

"As here applied it has taken from the Bank the following property rights recognized by the law of Kentucky:

1. The right to retain the lien until the indebtedness thereby secured is paid."

In the case of Wright v. Mountain Trust Bank, 300 U. S. 440, 81 L. Ed. 737, in which the court had under consideration the Frazier-Lemke Act as amended, the court said:

"It is not denied that the new Act adequately preserves three of the five above enumerated rights of a mortgagee. 'The right to retain the lien until the indebtedness thereby secured is paid' is specifically covered by the provisions in ¶ 1, that the debtor's possession, 'under the supervision and control of the court', shall be 'subject to all existing mortgages, liens, pledges, or encumbrances', and that:

'All such existing mortgages, liens, pledges,

> or encumbrances shall remain in full force and effect, and the property covered by such mortgages, liens, pledges, or encumbrances shall be subject to the payment of the claims of the secured creditors, as their interests may appear!!."

In the case of Borchard v. California Bank, 310 U. S. 311, 84 L. Ed. 1222, the court said:

> "As pointed out in the Wright case, supra, the secured creditors' rights are protected to the extent of the value of the property."

In the case of Consolidated Rock Products Co. v. DuBois, Vol. 85 Supreme Court, Law Edition, Advance Opinions, No. 9, page 603, which was a case arising under Section 77B of the Bankruptcy Act, the court said:

> "In the first place, no provision is made for the accrued interest on the bonds. This interest is entitled to the same priority as the principal."

In that case it was held that the stockholders of a corporation are not entitled to any consideration until after the creditors are paid in full.

In the case of Wright v. Union Central Life Insur. Co., Vol. 85 Supreme Court, Law Edition, Advance Opinions, No. 3, page 166, the Court, in discussing Section 75 of the Bankruptcy Act, said:

> "Safe-guards were provided to protect the rights of secured creditors throughout the proceedings to the extent of the value of the property."

The Court further said:

> "And the creditor will not be deprived of the assurance that the value of the property would be devoted to the payment of its claim."

As the property mortgaged is ample security for the payment of the mortgage debt, interest is collectible at the rate agreed upon to the time of payment of the indebtedness, and is secured by the lien of the mortgage the same as the principal of the debt.

The appellant by virtue of the lien of the mortgages is the owner of an interest in the mortgaged property equal to the principal and interest of his claim and as the value of the mortgaged property is greatly in excess of appellant's claim, the effect of the reduction of the interest on that claim is to take the property of appellant, to the extent of the difference between the contract rate of interest and the reduced rate and give it to the debtor or the unsecured creditors in violation of the Fifth Amendment to the Federal Constitution.

* * * * * * *

Subdivision (k) of Section 75 of the Bankruptcy Act (11 U. S. C. A. 203), provides:

> "Upon its confirmation, a composition or extension proposal shall be binding upon the farmer and his secured and unsecured creditors affected thereby: Provided, however, that such extension and/or composition *shall not reduce the amount of or impair the lien of any secured*

creditor below the fair and reasonable market value of the property securing any such lien at the time that the extension and/or composition is accepted, but nothing herein shall prevent the reduction of the future rate of interest on all debts of the debtor, whether secured or unsecured." (Italics ours.)

As the right of the mortgagee to the payment of the indebtedness secured by the lien of the mortgage in full when the property mortgaged is ample security for such payment, there is no more authority to deprive the mortgagee of his lien to the extent that it secures the payment of the interest than there is to deprive him of his lien as security for the payment of the principal of the indebtedness. This right of the mortgagee to the payment of interest, as well as principal, to the extent of the security furnished by the lien of the mortgage, is a vested right protected by the Fifth Amendment of the Federal Constitution.

Reading Subdivision (k), quoted above, in the light of the decisions hereinbefore cited, in which it was decided that where the property mortgaged is ample security for the payment of the mortgage debt, the right of the mortgagor to the payment of his debt in full is a a right protected by the Fifth Amendment to the Federal Constitution, the concluding words that "nothing herein contained shall prevent the reduction of the future rate of interest on all debts of the debtor, whether secured or unsecured" can only apply to a secured

debt where the security is insufficient and the creditor is entitled to participate with the unsecured creditors, as in the case of Sexton v. Dreyfus, 219 U. S. 339, 55 L. Ed. 244. Furthermore the concluding words of the subdivision above quoted cannot have any application where the debtor is not personally liable and the creditor must look solely to the lien of his mortgage for payment. Such a construction harmonizes these words with the express declaration "that such extension and/or composition shall not reduce the amount of, or impair the lien of any secured creditor below the fair and reasonable market value of the property securing any such lien at the time the extension and/or composition is accepted". To construe the concluding words of Subdivision (k) as authorizing the Court to reduce the rate of interest, where the debt does not exceed "the fair and reasonable market value of the property", would clearly render the statute unconstitutional in view of the decision in the Louisville Joint Stock Land Bank case, 295 U. S. 555, 79 L. Ed. 1593.

PROPOSAL OF DEBTOR WAS FOR AN EXTENSION AND NOT A COMPOSITION

In the proposal of the debtor (R., p. 2) it is stated: "Debtor proposes to pay all creditors in full." It is further stated that the unpaid balances on the claims of the secured creditors "to bear interest at the existing contract rate."

This is not a proposal for composition but a proposal for extension. The distinction between a com-

position and an extension proposal is discussed in the case of Heldstab v. Equitable Life Assurance Society, 91 Fed. (2d) 655. The court in the opinion in that case said:

> "Composition by creditors with their debtor in bankruptcy is an agreement between them that the latter will pay down and the former will accept a named per cent of their claims in full satisfaction. * * * *An extension proposal is an agreement on the part of the creditors that they* will extend the time within which their claims *are probably to be paid, in full, as to secured creditors on the terms proposed by the debtor and approved by the court.*" (Italics ours.)

Subdivision (1) of Section 75 of the Bankruptcy Act, Section 203, Title 11, U. S. C. A., recognizes the distinction between an extension proposal and a composition proposal, and provides that:

> "The court may, after hearing and for good cause shown, at any time during the period covered by an extension proposal that has been confirmed by the court, set the same aside, reinstate the case, and modify the terms of the extension proposal."

The proposal of the debtor in this case is an extension proposal, in which he agreed to pay all claims, including the claim of appellant, in full.

Considering the distinction between a composition proposal and an extension proposal, we submit that the authority granted by Subdivision (1)

"to modify the terms of the extension proposal" does not authorize the Court to substitute for the extension proposal a composition proposal which would be the effect of permitting the debtor to discharge his property from the lien of the mortgages securing the Bogart claim, by paying less than the amount agreed to be paid.

As the order reduces the rate of interest only on the appellant's claim, it is clearly in violation of the agreement with appellant resulting from the confirmation of the proposal.

* * * * * * *

Attention is directed to the fact that the legal rate of interest in Montana is six per cent (Sec. 7725, Revised Codes of Montana, 1935).

COHAN V. ELDER, 112 FED. (2d) 967

The case of Cohan v. Elder, 112 Fed. (2d) 967, was cited in the lower court as a controlling authority in support of the application for a reduction in the rate of interest.

A reading of the opinion in that case will disclose that at the time of the order reducing the rate of interest the property mortgaged was insufficient security. The court in the opinion, in discussing the value of the property, said:

> "The property well could be completely restored to a value exceeding any tax liens and appellants' debt in the 17 months still to elapse prior to the conclusion of the three-year period."

It should further be noted that the reduction of the rate of interest was made for only the period *"pending the court's administration"* and that the reduction applied to the interest on the claims of all creditors.

That case is also distinguishable for the reason that the debtor was personally liable for the mortgage indebtedness, whereas in this case the only liability is against the mortgaged property.

In the case before the court, as alleged in the petition for the reduction of interest, the claim is secured by a mortgage upon property "worth greatly in excess of the mortgage thereon". In the answer and cross-petition, filed on May 6, 1941 (R. p. 62), the debtor alleges:

> "That the said Frank Bogart is secured to an extent that to permit him to foreclose his said mortgages would enable him to take security worth Eight Hundred Thousand Dollars for a claim of approximately One Hundred Eighty Thousand Dollars".

* * * * * * *

As decided by the Supreme Court of the United States in the cases cited, the interest is just as much a part of the indebtedness secured by the mortgage as the principal, and the Court is clearly without jurisdiction to require appellant to accept less than the principal and interest of his claim. To construe the Bankruptcy Act as permitting a reduction of the amount of the principal or of the interest, where

the property, as in this case, is worth several times the indebtedness, would render the Act violative of the Fifth Amendment to the Federal Constitution.

Respectfully submitted,
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